Policy Statement on Income Tax Expense for Tax Pass-Through Entities

Revised 2/8/13

In several recent rate cases,[1] the Arizona Corporation Commission ("Commission") has been asked to impute income tax expense in the cost of service of so-called tax pass-through entities such as limited liability companies, Subchapter S corporations and partnerships. In each of these proceedings, the applicants presented testimony and evidence to the Commission supporting their request for including income tax expense. On the basis of this testimony and evidence, some commissioners expressed interest in reconsidering the income tax issue. In a Staff Meeting held January 12, 2011, the commissioners directed Utilities Division Staff to examine the merits of allowing income tax expense for tax pass-through entities in the generic docket captioned In the Matter of the Commission's Generic Evaluation of the Regulatory Impacts from the Use of Non-traditional Financing Arrangements by Water Utilities and their Affiliates.[2] A workshop was subsequently publicly noticed by Utilities Division Staff and held on March 25, 2011. Various participants in the generic docket made presentations, which were filed with Docket Control, addressing the arguments for and against including income tax expense in the cost of service of tax pass-through entities.

Because some commissioners were interested in reconsidering the question of imputed income tax expense, in early 2011 the Commission began to include an ordering paragraph in its rate case decisions for tax pass-through entities which recognized the possibility that the Commission might change its practice on the issue, and which specified a process for an affected utility to obtain a prospective increase in its revenue requirement through the filing of a petition under A.R.S. § 40-252 in the event the Commission did change its policy on imputed income tax expense. For example, the Commission included the following language in Decision 72177 (February 11, 2011) from the last Sahuarita Water Company rate case:

> IT IS FURTHER ORDERED that in the event the Commission alters its policy to allow S-corporation and LLC entities to impute a hypothetical income tax expense for ratemaking purposes, Sahuarita Water Company, LLC may file a motion to amend this Order prospectively, and Sahuarita Water Company, LLC's authorized revenue requirement hereunder, pursuant to A.R.S. § 40-252, to reflect the change in Commission policy.[3]

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[1] Sunrise Water Co. (Docket No. W-02069A-08-0406), Farmers Water Co. (Docket No. W-01654A-08-0502), Johnson Utilities, LLC (Docket No. WS-02987A-08-0180), Sahuarita Water Company, LLC (Docket No. W-03718A-09-0359), and Pima Utility Company (Docket Nos. W-02199A-11-0329 and W-02199A-11-0330).

[2] Docket W-00000C-06-0149.

[3] Decision 72177 at 45-46.

There are a number of states which allow income tax expense in the cost of service for tax pass-through entities. For example, in Suburban Utility Corporation v. Public Utility Commission of Texas, 652 S.W.2d 358 (1983), the Supreme Court of Texas held that recognition of income tax expense for tax pass-through entities is necessary:

> "The income taxes required to be paid by shareholders of a Subchapter S corporation on a utility's income are inescapable business outlays and are directly comparable with similar corporate taxes which would have been imposed if the utility operations had been carried on by a corporation. Their elimination from cost of service is no less capricious than the excising of salaries paid to a utility's employees would be. We therefore hold that Suburban [a Subchapter S corporation] is entitled to a reasonable cost of service allowance for federal income taxes actually paid by its shareholders on Suburban's taxable income or for taxes it would be required to pay as a conventional corporation, whichever is less."[4]

Based upon the evidence and testimony which has been presented in the recent rate cases before this Commission as well as the generic docket, we are persuaded that a tax pass-through entity should be allowed to recover income tax expense as a part of its cost of service and that its revenue requirement should be grossed up for the effect of income taxes. We are persuaded that the failure to include income tax expense needlessly discriminates against tax pass-through entities and creates an artificial impediment to investment in utility infrastructure. Neither of these outcomes serves the interests of rate payers. Thus, we hereby adopt a new policy which allows imputed income tax expense in the cost of service for limited liability companies, Subchapter S corporations and partnerships. While sole proprietorships are not technically tax pass-through entities, the arguments supporting the inclusion of income tax expense for tax pass-through entities are equally applicable in the case of sole proprietorships. Thus, the policy will apply to sole proprietorships as well as tax pass-through entities.

This new policy will be applied in pending and future rate cases. Also, companies that have been denied recognition of income tax expense in the past may make a filing under A.R.S. § 40-252 to modify the revenue requirement authorized in their most recent rate case order to include income tax expense prospectively from the date of an order of the Commission approving the A.R.S. § 40-252 filing.

We also desire at this time to provide guidance regarding how income tax expense for tax pass-through entities will be calculated in a fair and balanced way. We agree with the Supreme Court of Texas that the income tax expense for a tax pass-through entity should never be greater than it would be if the utility was a stand-alone C Corporation. Accordingly, tax expense will be determined as follows:

[4] 652 S.W.2d at 364.

1. Identify all taxable persons or entities and all non-taxable entities[5] (if any) which are owners of the tax pass-through entity. If the tax pass-through entity has an owner which is itself a tax pass-through entity, identify all taxable persons or entities and all non-taxable entities (if any) of such tax pass-through owner. Income tax expense shall be permitted based only upon the effective income tax rates of owners which have actual or potential state and federal income tax liability. The owner or owners of a tax pass-through entity shall not be required to submit personal income tax returns to the Commission, but shall submit documentation showing all owners of the tax pass-through entity, the respective ownership percentages of each owner, and the tax status of each owner (i.e., whether the owner is a taxable entity or a non-taxable entity).

2. Identify the tax filing status (ie. Married filing jointly, married filing single, single, etc.) of the individuals and entities from step 1 above.

3. Compute the actual effective income tax rate for each owner of the tax pass-through entity based upon such owner's proportionate share of taxable income at the proposed revenue level using applicable statutory federal and state income tax rates.

4. Calculate a weighted average effective income tax rate for the combined ownership of the tax pass-through entity.

5. Use the weighted average effective income tax rate for calculating the income tax allowance.

6. Also, calculate the income tax allowance (federal and state) for the tax pass-through entity as though it were a stand-alone Subchapter C corporation.

7. The authorized income tax allowance for the tax pass-through entity shall be the lower of: (i) the income tax allowance using the weighted average effective tax rate for the combined ownership calculated using steps 1 through 5 above; and (ii) the income tax allowance assuming the tax pass-through entity is a stand-alone Subchapter C corporation calculated using step 6 above.

[5] Non-taxable entities are not-for-profit corporations, municipal corporations or other entities which do not have actual or potential state or federal income tax liability.